

30. We appreciate the proposal by AT&T/Bell Atlantic/NYNEX to further reduce access charges in a second stage restructuring. We have some concern, however, that this proposal results in shifting costs, rather than subjecting them to marketplace forces, which may eliminate those costs altogether.

31. Notice ¶ 168.

32. The Communications Act imposes that obligation on the Bell Operating Companies. 47 U.S.C. §272(e)(3). Competitive fairness and efficient recovery of network costs requires that such an obligation also apply to all other ILECs that offer interstate interexchange services.

33. The Commission would, of course, continue to review and to adjust interstate access rates annually in accordance with its price cap plan. It could address other implementation issues at that time.

34. Such additional pricing flexibility might include greater freedom to deaverage rates geographically or among customer groups, and flexibility to depart from or to alter particular access rate elements. As competition develops, the Commission could also consider relaxing somewhat the constraints discussed above with respect to imputation and the pricing of originating and terminating access.



DEPARTMENT OF JUSTICE

Antitrust Division

JOEL I. KLEIN

Acting Assistant Attorney General

Main Justice Building
950 Pennsylvania Avenue, N.W.
Washington, D.C. 20530-0001
(202) 514-2401 / (202) 616-2645 (f)
antitrust@justice.usdoj.gov (Internet)
<http://www.usdoj.gov> (World Wide Web)

April 24, 1997

EX PARTE OR LATE FILED

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APR 24 1997

Mr. William F. Caton
Acting Secretary
1919 M Street, N.W., Room 222
Federal Communications Commission
Washington, D.C. 20554

Section 101

Re: Access Charge Reform, CC Docket No. 96-262, et al.

Dear Mr. Caton:

Today, the attached letter was delivered by the undersigned on behalf of the Department of Justice to the office of Chairman Hundt in connection with the above referenced proceeding.

Please call me if you have any questions.

Sincerely,

Joel I. Klein
Joe I. Klein

cc: Chairman Reed E. Hundt
Commissioner James H. Quello
Commissioner Rachelle B. Chong
Commissioner Susan Ness



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*Main Justice Building
950 Pennsylvania Avenue, N.W.
Washington, D.C. 20530-0001
(202) 514-2401 / (202) 616-2645 (f)
antitrust@justice.usdoj.gov (Internet)
<http://www.usdoj.gov> (World Wide Web)*

April 24, 1997

Ex Parte

Chairman Reed Hundt
Federal Communications Commission
Room 814
1919 M Street, NW
Washington, DC 20554

Re: Access Charge Reform, CC Docket No. 96-262, et al.

Dear Chairman Hundt:

By commencing a proceeding to consider reforming its access charge rules,¹ the Federal Communications Commission (the "FCC" or the "Commission") has embarked on another critical step in its journey towards establishing the framework necessary to foster vigorous competition in all telecommunications markets as envisioned by the Telecommunications Act of 1996 (the "1996 Act"). The United States Department of Justice (the "Department") believes that reform of the system of interstate access charges, although not specifically mandated by Congress, is essential to achieving the goals of the 1996 Act -- namely, the promotion of competition in access and local exchange service markets and the realization of its attendant consumer benefits. Thus, we offer the following observations and suggestions as the Commission undertakes this important task.

¹See Access Charge Reform, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262, et al., FCC 96-488 (released Dec. 24, 1996).

I. INTRODUCTION

After the divestiture of AT&T's local service operations to its former operating companies, the FCC instituted the current system for collecting interstate access charges. This system governs the charges that all interexchange carriers ("IXCs") and end users pay to the incumbent local exchange carriers ("ILECs") for the origination and termination of long distance calls. The new competitive landscape engendered by the 1996 Act, however, demands that the FCC revise its long-standing access charge system to facilitate free and fair competition in all telecommunications markets so that consumers may reap the full benefits of a competitive marketplace, including lower prices, increased innovation, and higher quality products and services. In recognition of this critical need, the Commission issued a Notice of Proposed Rulemaking ("Notice" or "NPRM") and asked for comments.

The Department, one of the federal agencies responsible for enforcing the antitrust laws and promoting competition, has played an active and ongoing role in the telecommunications industry throughout this century. As we made clear in our comments relating to the Commission's historic *Local Competition Order*,² the Department's experience highlights that consumers should gain significant benefits upon the advent of substantial local telephone competition. Our past experience suggests that competition will drive prices towards cost-based levels, thereby maximizing output and the use of telecommunications services, while at the same time reducing costs and benefitting consumers through increased innovation and enhanced service offerings. The FCC, like the Department, seeks to foster a competitive environment in

²See Comments Of The United States Department of Justice, in Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, filed May 16, 1996.

which these benefits can be achieved. As the Commission has recognized, reforming the existing access charge rules is vital to ushering in this new era. To assist the Commission as it takes on this unprecedented and essential review of access charges, we set forth below our views on the Principles for Access Reform and Deregulation (Part II), Rate Structure Issues (Part III), and Rate Level Issues (Part IV).

II. PRINCIPLES FOR ACCESS REFORM AND DEREGULATION

A. Overview

The ongoing proceeding to reform access charges constitutes one of a series of interrelated proceedings designed to foster the development of competition in all telecommunications markets. In the first of these rulemakings, culminating in the Commission's historic *Local Competition Order*, the Commission adopted rules to ensure non-discriminatory, cost-based access to elements of the ILECs' networks on an "unbundled" basis. These rules were designed to permit efficient entry into local exchange and access markets, and to facilitate the development of competition in these previously monopolized markets so that consumers could benefit from greater choice, higher quality and lower prices in their telephone service. The Commission recognized at that time, however, that implementation of the local competition rules would constitute only one of the important regulatory reforms necessary to achieve the consumer benefits that would come from a fully competitive marketplace. In particular, the Commission stressed the need to reform the existing mechanisms for promoting universal service and for regulating interstate access charges.

The current mechanisms, designed to accomplish important social objectives in an environment of regulated monopolies for local telephone service, are fundamentally

incompatible as presently structured with competitive markets for local telephone services. This incompatibility arises from the fact that these regulatory mechanisms encourage or require departures from cost-based pricing in order to provide a variety of implicit subsidies from some services or customers to others. For example, certain policies have lead to inflated access charges in low cost areas in order to subsidize other high cost areas, i.e., enabling the ILECs to serve those areas at below-cost prices. Similarly, interstate access charges are currently structured to provide an implicit subsidy for local services by pricing long distance services above cost. While the social goal of universal service is still critical, the means of funding this goal must be adjusted to fit the competitive environment.

Some claim the current regulatory regime may have also required or encouraged some ILECs to incur certain costs in excess of the forward looking economic cost ("economic cost") of providing access services, and under some circumstances, the Commission may conclude that sound regulatory policy or legal requirements support the recovery of such costs. That is, those costs could theoretically be "stranded" as a result of potential changes in access regulation (e.g., a substantial downward prescription in current access prices), unless such changes are accompanied by the creation of other recovery mechanisms. At this point, however, the Department expresses no view on the likelihood that any ILEC may be able to establish such stranded costs in the event of any contemplated regulatory changes. Nonetheless, if the Commission concludes that some ILECs will advance such claims in the wake of its reform of access charges, we suggest that the Commission take steps to prepare for evaluating such claims, and, if necessary, for developing appropriate mechanisms to recover stranded costs in a manner that minimizes the distortion of consumption and investment decisions.

The present access charge system also subsidizes low volume users by pricing certain

non-traffic sensitive costs on a traffic sensitive basis. For example, the cost of the local loop is largely a fixed cost, but it is recovered in significant part through the per-minute Carrier Common Line Charge. This type of arrangement -- if retained over the long term -- would be incompatible with a competitive market in that it, among other things, would encourage inefficient bypass of the local exchange network and lead to an under-usage of access services.

The emergence of competition over time can be expected to make it increasingly difficult for the access charge system to implicitly cross-subsidize users within the system, since competition tends to drive prices towards the economic cost of the provided service. Thus, in order to protect the very important social goals that have been served by the historical functions of the access charge system -- particularly the goal of maintaining affordable universal service -- the transition to competitive markets requires the implementation of new mechanisms that will function effectively and efficiently in a competitive environment.

A failure to address these sorts of issues would inevitably impede the development of competition (thereby forestalling the lower prices and higher quality services that it would bring to consumers), undermine the ability to continue to serve the social goals served by the current implicit subsidies, distort competition between incumbents and entrants, or some combination of the above. For a market to function effectively, competitors must be free to enter when prices exceed economic costs and to underprice the incumbent in such instances. If this competitive process operates effectively in the context of the present access charge system, the ILECs will begin to lose the profits they previously earned in the markets in which they charged prices exceeding economic costs. If competition eliminates those profits, it would be inappropriate to require the ILECs to incur losses in other markets by providing services at below-cost prices. Such a requirement would also prevent entry by competitors which might serve those previously

subsidized markets more efficiently than the ILEC.

A failure to develop new, explicit and competitively neutral mechanisms to replace the system's present reliance on implicit subsidies also would frustrate the development of competition in the markets that ILECs presently serve at above-cost prices by not setting clear rules to govern the emergence of competition in a previously-regulated market. Without such rules, the ILECs may well claim that competition focused on the attractive markets would deprive them of the opportunity to remain financially competitive if they were required to continue serving those less attractive -- i.e., higher cost -- markets at below-cost rates. Thus, absent the implementation of new explicit and competitively neutral funding mechanisms for these important universal service objectives, each potentially procompetitive policy choice that regulators will face would be burdened at the outset by the contradictory challenge of having to meet important social goals with traditional mechanisms that, at their core, rely on the market power of the ILEC.

Attempting to maintain the system of implicit subsidies also would undermine the incentives that are fundamental to the success of competitive markets. Customer losses by incumbents to entrants would cut into both ILEC profits and the availability of revenue to fund service to high cost customers alike, but in undeterminable amount and proportion. The effect of these losses might well be an expectation on the part of the ILECs to a degree of regulatory indemnification, which, in turn, would blunt their performance incentives and keep them focused on the regulatory process rather than the market. If relieved of the burden to provide any implicit subsidies, the ILECs would know up-front they could not obtain any such compensation for a failure to perform in the marketplace.

Recognizing the imperative of reforming the present access charge system and the

implicit subsidies it provides for universal service, the Commission properly characterized its *Local Competition Order* as the first of a trilogy of regulatory reforms, to be followed by universal service reform and access charge reform, and adopted transitional devices to ensure that the interstate access revenues of ILECs would not be severely undermined by competitive forces before the Commission could complete all portions of this trilogy. As it now considers alternative approaches to access charge reform, the Commission should follow the principles described below. Adherence to these principles necessarily will be tempered, at least in the short term, by a variety of legal, administrative, and equitable concerns, all of which will require careful balancing by the Commission. Although the Department recognizes that the entire process of access charge reform is likely to require a transition period, we urge the Commission to adhere to these principles to the greatest degree possible as it phases in the necessary reforms. Where the Commission concludes that departures are necessary, we recommend that the Commission limit such departures to appropriate transitional mechanisms.

B. Guiding Principles

The Commission has properly identified the most important principle as its overriding goal in this proceeding: "to adopt revisions to our access charge rules that will foster competition for these services and eventually enable marketplace forces to eliminate the need for price regulation of these services" (Notice ¶ 140). The Department wholeheartedly supports this goal and the Commission's efforts to develop and implement mechanisms to swiftly and fairly accomplish this result. The operation of marketplace forces in a fully competitive access market can be expected to yield substantial consumer benefits, compared even to the most enlightened and effective regulatory scheme. A competitive marketplace can be expected to yield efficient

prices for access services, to generate innovation in access services, to create proper incentives for investment in new facilities, to minimize the risks of anticompetitive behavior, and to do these things without the substantial administrative costs and delays associated with regulatory efforts to accomplish those objectives.

The Commission also properly recognizes that a period of traditional regulation will be necessary until competition fully takes root. At present, competition in access markets, and in the closely related local exchange markets with which they often share scope economies, is far too limited to warrant full deregulation. The ILECs still maintain a substantial degree of market power in most switched access markets, and there is considerable uncertainty concerning the pace at which effective competition will develop in these markets. Therefore, policies designed to accelerate the development of access competition must be accompanied by policies to constrain the exercise of market power during the transition to more fully competitive markets. After a period of transitional regulation, the market would ideally reach an efficient pricing structure for access services, i.e., one where access services are priced at their underlying economic cost. Until more competition emerges, however, the Commission will need to continue regulating the pricing of access services.

All agree that current access charges substantially depart from an efficient pricing structure, but the commenters to the Commission's Notice have differed sharply as to the reasons for this departure. As suggested by the description above, some commenters have suggested that this departure stems from implicit contributions designed to further universal service objectives (e.g., support for high cost areas) and from the improper allocation of costs to the interstate jurisdiction (i.e., to subsidize local telephone service). Other commenters suggest that current access prices exceed their economic cost because of ILEC inefficiencies, or because present

access charges do not reflect recent productivity gains or allow the ILECs an excessively high rate of return. Finally, some commenters counsel against implementing various measures to reduce access charges on the ground that they would leave the ILECs with some stranded costs that they are entitled to recover.

We recognize that determining to what extent each of the above factors account for the present level of access charges and devising the appropriate solutions to bring them down to economic cost, may require work beyond the current access charge proceeding to implement effectively the principles outlined herein. Nonetheless, we believe that the access charge proceeding will enable the Commission to commit to addressing each of the aforementioned issues over a relatively short period of time. As to each of these issues, we recommend that:

(1) If the Commission institutes a basic system of explicit universal service subsidies as a result of its universal service proceeding that leaves any implicit subsidies in place, it should identify such subsidies and target them for eventual replacement by explicit and competitively neutral universal service mechanisms. Such mechanisms should be structured so as to create the least ongoing distortion of purchase and investment decisions in competitive markets.

(2) The Commission should identify -- or commit to taking the necessary steps to identify -- any costs presently recovered through interstate access charges that should be properly allocated as a cost to the intrastate jurisdiction, and undertake to reform the separations process accordingly.

(3) The Commission should also prepare for any claims that its reforms will leave the ILECs with stranded costs that they should be entitled to recover by commencing a proceeding to establish the basic accounting rules for these claims as well as designing a competitively neutral mechanism to raise the funds -- if any -- that are necessary to reimburse the ILECs for

any expenditures to which the Commission determines they are entitled and have been denied an opportunity to recover.

(4) To the extent that it is able to do so in its ongoing price cap proceeding,³ the Commission should evaluate, among other things, the productivity factor and cost of capital adjustment used to establish the level of access charges in order to determine whether they are allowing the ILECs an excessive recovery and, if necessary, adjust the price cap accordingly. Moreover, we recommend that the Commission not implement any restructuring of access charges until it completes its price cap proceeding.

After taking each of the above steps, the Commission will then be in a position to determine what amount, if any, of the sums presently collected through the access charge system stem from ILEC inefficiencies or excess profits, which the ILECs should not be entitled to recover. At that point in time, the Commission will be in a position to prescribe access rates to economic cost, if market forces have not already pushed them to that level.

The complete implementation of these principles will, we believe, create an access charge structure fully compatible with the competitive markets envisioned by the 1996 Act. Accordingly, we view these principles as instrumental to ensuring that consumers receive the greatest amount of the benefits from appropriately priced access services as soon as possible. These principles will also avoid the competitive distortions and the potential unfairness to new entrants and/or to ILECs and their shareholders that inhere in efforts to maintain prices that diverge from economic costs. Finally, these principles will ensure that the important objective of maintaining universal service can be achieved consistently with the requirements for universa

³Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659 (1995).

service mechanisms set forth in Section 254 of the 1996 Act and in a manner that will not unfairly disadvantage the ILECs or new entrants.

To the degree that it is possible for the Commission to adhere to the principles embodied in the approach outlined above in the near term, the Commission should do so. We recognize that complete implementation of these principles may take some time, but we emphasize that the sooner they can be put in place so as to foster full and fair competition, the sooner consumers can expect to enjoy competition's attendant benefits, including lower prices and enhanced service offerings. To assist the Commission in implementing a principled reform of its access charge rules, we offer the following specific suggestions, discussed in more detail below:

First, as addressed in Part III, we recommend reforming the current rate structure to establish a price structure which reflects the manner in which costs are incurred. Specifically, we recommend that, as a result of this proceeding, the Commission establish traffic sensitive charges to recover traffic sensitive costs, and non-traffic sensitive charges to recover non-traffic sensitive costs. This reform will substantially improve the efficiency of access markets, and facilitate the transition to competitive markets. At the same time, this restructuring will benefit the ILECs by eliminating the artificial incentives for competitive entry targeted specifically at high-volume customers.

Second, as explained in Part IV.A, we recommend that, as part of its current price cap proceeding, the Commission address the question of whether the productivity factor and cost of capital adjustment allow for an excessive recovery such that the price cap needs to be adjusted. If the Commission foresees that its price cap proceeding will call for an adjustment of the price cap in the near term, it may wish to delay the implementation of its plan for restructuring access charges so that it would coincide with any adjustment to the price cap.

Third, as made clear in Part IV.B, we recommend that the Commission not resort to fully prescribing rates to economic cost until it first addresses the necessary transitional issues outlined above. Rather, we favor the market-based approach outlined in the Notice. We acknowledge that there is considerable uncertainty today about the speed and uniformity with which competition in access markets will develop and that this uncertainty counsels against relying permanently and exclusively on market-based approaches for reducing rate levels to economic costs. Nonetheless, the gradual downward pressure on access charges created by market forces as they emerge will provide the Commission with sufficient time to implement the other measures necessary to transition from a regulated to a competitive market. Once the Commission implements these other transitional measures, it will then be in a position to evaluate whether market forces have driven access rates to economic cost, and if not, to prescribe rates to economic cost at that time. The Department emphasizes the importance of the Commission reaching this point as expeditiously as possible.

III. RATE STRUCTURE ISSUES

The Commission's Part 69 access charge rules establish the rate structure by which the ILECs recover the switched access costs currently assigned to the interstate jurisdiction. This rate structure was designed to operate in an environment in which the ILECs were the exclusive providers of local exchange and access services. In the wake of the 1996 Act, this system needs to be revised to facilitate a new era of open competition for all telecommunications services, including those traditionally the sole province of the ILECs. Indeed, as the Commission has recognized (Notice ¶ 43), inefficient mandatory rate structures are one of the reasons why current per-minute interstate access charges exceed economic cost. Since these rate levels

cannot be sustained in a fully competitive environment, the Department strongly endorses the Commission's tentative conclusion (Notice ¶ 56) that the vision of the 1996 Act calls for a more economically rational access rate structure. In particular, access charges should be assessed in a manner that reflects the way costs are actually incurred; that is, non-traffic sensitive costs should be recovered through non-traffic sensitive charges, and traffic-sensitive costs should be recovered through traffic-sensitive charges.

There are two major categories of fixed costs that are currently recovered in part through per-minute access charges. The first category is the costs associated with the ILECs' common line or subscriber loop, which are driven primarily by loop length and customer density, not by the level of usage. At present, ILECs recover their common line costs through two charges: (1) the subscriber line charge ("SLC"); and (2) the carrier common line charge ("CCL"). The SLC is a fixed, per line assessment which appears as an additional charge for basic service on the monthly phone bill a customer receives from his or her local service provider. The SLC is presently capped at \$6 per month for multi-line business customers and \$3.50 for residential and single-line customers. Any interstate loop costs not recovered through the SLC are collected in the form of a per-minute CCL charge assessed on all interexchange carriers. These usage-based CCL charges accounted for approximately \$3.7 billion in regulated access revenues for the Class A ILECs in 1995. (Notice ¶ 29).

The second category of fixed costs currently recovered through traffic sensitive charges are associated with local switching services. Local switching involves the process of routing a call coming in on one line onto trunks leading to the IXC's point of presence in an area ("POP") or from the POP to a line for terminating access based on the telephone number dialed by the end user placing the call. Current FCC rules require the ILECs to charge per-minute rates for

the recovery of all local switching costs. The Commission has correctly acknowledged (Notice 72) that a substantial portion of local switching costs are non-traffic sensitive. These costs would include, for example, the costs of line cards or line-side ports which do not vary with the amount of traffic carried over the loop. Local switching charges accounted for \$4.2 billion in Class A ILEC access revenues during 1995. (Notice ¶ 29).

The fundamental problem with the existing rate structure is that recovering non-traffic sensitive loop and switching costs in the form of per-minute access charges ensures that interstate access charges will exceed the economic cost of providing those services to certain customers. In essence, the existing rate structure artificially raises the variable cost of providing interexchange services, so that high-volume toll users are compelled to pay charges to their IXCs that typically exceed the costs associated with serving those customers. The inefficiencies of the current rate structure thus translate directly to increased per-minute long distance rates charged to all toll consumers. Accordingly, restructuring of the access charge system to align non-traffic sensitive costs with non-traffic sensitive charges should immediately permit reductions in per minute long distance rates that will directly benefit all toll consumers. These reductions should, in turn, stimulate some increased demand for long distance services and promote a more economically efficient level of network usage.

In addition to the obvious benefits of lower long distance rates, rate restructuring will also reduce the distorted market entry incentives created by the existing rate structure. By artificially increasing per-minute interstate access charges above their true economic costs, the current rate system discourages competitive service offerings to lower volume users while simultaneously encouraging inefficient entry targeted at high volume users. Likewise, high volume long distance customers are encouraged to bypass the ILECs' switched access system

entirely through the use of special -- i.e., dedicated line -- access arrangements even where such bypass is not economically efficient. Rate restructuring that establishes recovery mechanisms that are consistent with the nature of the costs being recovered will also address these inefficiencies, thereby bringing the benefits of competition to low volume users and encouraging entry only where it would be efficient. Accordingly, the Department urges the Commission to correct the existing inefficiencies of the current rate structure so as to ensure that non-traffic sensitive loop and switching costs are recovered through non-traffic sensitive charges. The Department further recommends that the timing of this restructuring coincide with the completion of the Commission's price cap proceeding.

IV. RATE LEVEL ISSUES

As noted above, even if implicit subsidies for universal service and intrastate services are fully removed from the access charge system, the access prices permitted by current regulation may still exceed the sum of the economic costs of providing access services and other costs, if any, that the ILECs should be allowed to recover as a matter of sound regulatory policy and or law. This potential gap may result from the combination of a variety of factors including ILEC inefficiencies in providing access services, the limited ability of regulation to constrain the exercise of market power of (i.e., price charged by) the ILECs, and evolving technology, among others. In short, the Department believes that the Commission should establish an approach to this issue that most responsibly, expeditiously, and effectively (1) removes those costs from the access charge system that should not be there by making any necessary adjustment to the price cap regime; (2) reimburses the ILECs for any valid costs they incur or have incurred (e.g., universal service subsidies) through explicit, competitive neutral mechanisms; as well as (3)

seeks to bring access charges down to economic cost. As we see it, this process involves one more immediate and one ongoing part: (A) an adjustment of the price cap that may be undertaken as part of the ongoing price cap proceeding (e.g., to account for recent productivity gains and any over-recovery on the cost of capital); and (B) a framework for effectively addressing the necessary transitional issues and bringing access rates down to economic cost.

A. Price Cap Review

The Commission's Notice asks whether revisions to the existing price cap regime may be an appropriate method for applying downward pressure on access rates. (Notice ¶¶ 231-235). If the Commission adopts a fully prescriptive approach for bringing access levels to economic cost in this proceeding, these revisions will be unnecessary. If, as the Department suggests, the Commission uses a market-based approach while it proceeds with the transitional measures to make its access system compatible with the new competitive environment, the Department believes that the Commission should, as part of its ongoing price cap proceeding,⁴ evaluate, among other things, the productivity factor and cost of capital adjustment to determine whether the price cap system is allowing the ILECs an inappropriate recovery. Given that the Commission's last consideration of its price cap regime acknowledged the possibility that the productivity factor needed to be adjusted and the price cap regime will need to be modified in any event to accommodate a reform of the access charge system,⁵ the Commission should use its ongoing price cap proceeding to ensure that the new access charge regime is not allowing the

⁴See footnote 3, supra.

⁵Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961 (1995).

ILECs an inappropriate recovery.⁶ Indeed, because the 1996 Act set forth a new regulatory environment, it is particularly appropriate at the present time to make any necessary adjustments to the price cap regime. Finally, the Department recommends that the Commission time the effective date for restructuring access charges to coincide with the completion of its price cap proceeding.

B. Framework for Reducing Rate Levels

In addition to any appropriate adjustment to the existing price cap, the Commission has identified two possible approaches which might be used, individually or in combination, to reduce access prices to appropriate levels. A "market-based" approach would rely largely on emerging competition to reduce access prices, and would grant ILECs increasing flexibility in pricing access services during the transition to competitive markets. A "prescriptive" approach would rely principally on direct regulatory measures to reduce access prices.

As explained in Part II, the Department advocates that the Commission rely, at least initially and in significant part, on a market-based approach to allow the Commission to undertake the necessary measures to address the inflated level of access charges (i.e., their divergence above economic cost). A fully prescriptive approach bears the virtue of immediately removing any excess charges contained within the current access charge regime. Without an adequate mechanism to address the issues of implicit universal service subsidies, the overallocation of costs to the interstate jurisdiction, and the proper recovery of stranded costs (to

⁶The Department recommends that any readjustment to the productivity factor be based on an industry-wide estimate, rather than a firm-by-firm readjustment. A firm-by-firm readjustment would eliminate cost-reducing incentives by effectively punishing the firms that have reduced their costs the most.

the extent that any exist), however, we think it unwise to push ahead with a full prescriptive cut in access charges at this point in time. A market-based approach, on the other hand, will allow competitive pressures to bring access charges to economic costs in a more gradual fashion, allowing the Commission time to address the necessary transitional issues.

We acknowledge that the market forces that will pressure access charges towards economic cost are likely to take some time to materialize for most customers and in most areas. At present, facilities-based competitors to the ILECs serve only a minuscule fraction of switched access customers. These competitors operate only in limited geographic areas, and have focused on serving customers which offer the largest revenue opportunities in relation to the costs of constructing network facilities. Whether measured by number of access lines or by access revenues, these competitors have very small market shares. Because of the cost and time needed to construct facilities, as well as the many other impediments to entry and expansion, we do not expect fully independent facilities-based competition to discipline most access prices in the near term, although such competition may serve to limit the ILECs' market power within discrete market niches.

Over the longer term, the competitive significance of fully independent facilities-based competitors is more promising, though still uncertain. Alternative local distribution technologies, such as wireless loop technology or hybrid fiber/coax networks, eventually may permit such facilities-based competition for a large proportion of customers, but the viability of these alternative technologies remains unproven, both technically and economically. Absent the development of these or other new technologies, fully independent facilities-based competition is unlikely to reach most segments of the market for a considerable period of time.

Thus, in the immediate future, the development of access competition will be dependent

on the use of the ILECs' unbundled network elements. The Department strongly supports the Commission's continuing efforts to successfully implement the requirements of the 1996 Act by ensuring full compliance with sections 251 and 252 and the *Local Competition Order*. The Commission's Notice acknowledges the importance of unbundled network element competition, among other ways, by proposing that appropriate provisioning and pricing of these elements be included among the "triggers" that would permit additional pricing flexibility when ILECs face potential access competition. In the Department's view, the appropriate provisioning and pricing of the necessary elements cannot alone be expected to assure the development of such competition, or guarantee its imminence. Rather, a variety of other factors will be critically important to the speed and extent to which such competition emerges.

First, it is still not clear how many customers may be served profitably using unbundled network elements, even if those elements are available at geographically de-averaged prices reflecting economic costs. For the most part, final cost studies for unbundled network elements remain to be completed, and entrants who wish to use unbundled network elements will have many network costs in addition to the cost of the elements they obtain from ILECs. Specifically, they will incur the cost of unbundling the elements, the cost of ordering and provisioning them, and the cost of combining them with the facilities of their own which they choose to utilize.

Second, there is no assurance that technical problems associated with the use of unbundled network elements will be surmounted quickly or cheaply. While many forms of unbundling appear to be feasible today, the implementation of unbundling at a commercially significant scale has not yet been accomplished. If unanticipated technical difficulties arise in the implementation of unbundling, competition could be delayed.

Finally, in addition to these potential obstacles to the development of competition for

originating access, there are other factors that may limit the ability of competition to constrain prices for terminating access in particular. As the NPRM notes, decisions to place calls and the responsibility for paying for calls lies with the calling party, while the choice of the service provider for call termination rests with the called party. Because of these facts, terminating access may not face the same competitive pressure as originating access. See Notice ¶¶ 271, 272.

In crafting its plan to implement the necessary transitional measures and to reduce access charges, the Commission must balance several different factors. We are thus cognizant that several different avenues, including the adoption of specific time frame triggers for prescriptive reductions as certain transitional measures are achieved, may all reach the same result. In that spirit, the Department offers its suggested approach, with the recognition that any number of modifications would approximate the balance struck by -- and the principles embodied -- within our proposal.

In essence, the Department proposes that the Commission adopt a four part plan. First, the Commission should reform the rate structure as outlined in Part III above, and, in tandem, adjust the price cap regime as appropriate, see Part IV.A. In combination, these measures should lead to a reduction in access rates. Second, the Commission should allow market forces to pressure access rates towards competitive levels over time. Third, the Commission should use the gradual downward pressure on rates to allow it to address the transitional issues outlined in Part II above, explicitly adjusting rates as it does so. Finally, after completing its implementation of the necessary transitional measures, we recommend an evaluation of the market-based approach, with a downward prescription of rates in the event that the market fails to push rates to their economic cost.

The prime virtue of a market-based approach is that it will allow the Commission to address three basic transitional issues before bringing access rates down to economic cost: (1) replacing the implicit universal service subsidies in the system with explicit ones; (2) removing any overallocation of costs from the interstate jurisdiction; and (3) assessing the extent (if any) to which these reforms might inappropriately prevent ILEC recovery of stranded costs and designing a mechanism to allow the recovery of any such costs in a competitively neutral manner. With regard to "stranded costs," we believe it useful and appropriate for the Commission to distinguish between ILEC investments incurred prior to a fixed date (e.g., the date of enactment of the 1996 Act, or the date of the Commission's access charge reform decision) and any costs incurred after that date (See NPRM, ¶ 255). Ideally, the Commission would establish permanent rules to assure appropriate recovery of the latter on a going-forward basis. As for investments left "stranded" as a result of the change in regulatory regimes, the Commission should undertake to develop some basic accounting rules to determine the extent (if any) to which these costs exist, and to establish a competitively neutral recovery mechanism that would create the least ongoing distortion of purchase and investment decisions in competitive markets to collect the funds necessary to reimburse the ILECs.⁷

At this time, we do not believe it is possible to determine whether such "stranded costs" will exist, or if so, what their magnitude might be. Any such determination will depend, in part, on the policies chosen by the Commission in this proceeding and in its universal service reform. The risk of stranded costs will be greater if the Commission chooses a prescriptive approach to access reform that results in the immediate reduction of access prices to economic costs, but

⁷Structuring a recovery mechanism as a charge that varies with usage is likely to distort price signals. To avoid such distortion, recovery should not be tied to usage.

even if the Commission adopts such policies, we do not believe that ILECs have established at this time that they would necessarily incur such stranded costs, or the magnitude of any such costs that might exist. If the Commission chooses to rely in significant part on a market-based approach to access reform, the uncertainty is greater still, since even if there are certain costs that might otherwise be stranded, ILECs may well have an opportunity to recover these costs. Under any approach to access reform and universal service reform, consideration of stranded cost claims would also need to resolve a variety of questions, including the proper accounting of universal service support revenues and the relevance of revenue opportunities in other markets, such as that offered by the ability to offer in-region, inter-LATA services.

Given the advent of competition in a market previously regulated as a natural monopoly, it seems likely that at least some ILECs will claim that they have been denied an opportunity to recover their stranded costs. Again, the Department takes no position as to whether the shift in the regulatory environment will in fact leave the ILECs with either an inappropriate under- or over-recovery of any such costs. Nonetheless, given the likelihood that the Commission will face such claims once competition begins to develop (or once access rates are prescribed to economic cost), the Department recommends that the Commission initiate a proceeding -- possibly in cooperation with the States -- to ascertain the basic principles governing how the Commission will evaluate such claims. This proceeding would seek to determine questions that would arise in any stranded cost calculation such as whether the ILECs' opportunities to provide long distance services should be considered in evaluating opportunities for cost recovery. Similarly, this proceeding could determine what competitively neutral mechanisms could be employed to raise any revenue necessary to allow the ILECs to recover such costs. By answering these and other such questions in advance of the Commission's actual consideration

of any claim that an ILEC has been denied an opportunity to recover its legitimately incurred costs, the Commission will be best prepared to address those issues once any such claim is ripe and is presented to the Commission.

In sum, the Department reaffirms the commitment we made in our filing in the *Local Competition* proceeding to pricing at economic cost as a necessary precondition to full and effective competition in all telecommunications markets. We recognize, however, that the Commission first needs to undertake a series of transitional measures before it will be in a position to prescribe access charges to cost. Indeed, as the Commission undertakes separations reform and institutes a comprehensive system of explicit universal service subsidies, it will be able to reduce access charges to account for the system's present provision of implicit subsidies. Thus, at the proper time, the Commission can prescribe access rates to economic cost and will be prepared to face any claims that the ILECs are saddled with any remaining obligations to serve areas below cost or have been left with any stranded costs. Of course, to the extent that competition has developed in earnest, at least in certain areas, this prescription may be far more limited than one undertaken at this point in time.

VI. CONCLUSION

The Commission's access charge proceeding offers an opportunity to take a crucial step in the transition from a regulated to a competitive telecommunications marketplace. By rationalizing the current access charge rate structure, replacing implicit subsidies with explicit ones, and undertaking the transitional measures necessary to ensure that access prices reflect the economic cost of access services, the Commission can help make possible the goals of the 1996